

## **Chapter 15. STRENGTHENING “PERFORMANCE” IN PUBLIC EXPENDITURE MANAGEMENT**

*“A man kept searching for his wallet under the street lamp because, he said, it was too dark in the back alley where he had lost it.”*

### **A. THE GENERAL ISSUE**

#### **1. Why measure performance in the public sector?**

Mechanically transposing private sector practices and methodologies to the public sector is analytically incorrect and inappropriate in practice. For private production in a competitive market, and for the enterprise as a whole, the worth of the activity is most easily measured by the price the buyer is willing to pay; the net social utility of the producer is well approximated by his profits during a given period, the “bottom line”; and persistent losses will drive companies out of business.<sup>1</sup> This is so, however, only when the buyer gets all the benefits of the product and (indirectly) pays all the costs. When indivisibilities and external effects exist (positive, or negative such as water pollution), or where there cannot be a competitive market as for public goods, the “bottom line” is not as easy to define, the activity is assigned to the public sector, and the measurement of the impact of public sector activity therefore becomes a major and complex issue.<sup>2</sup>

On the other hand, to limit the notion of public “performance” *only* to compliance with budgetary appropriations, or to literal observance of rules and regulations, leads over time to forgetting the real purpose of spending monies obtained from the public at large. Eventually, this generates a “culture” of means rather than ends, disregard for the public, and the legendary bureaucratic mentality that considers it a success to formulate tight and internally consistent controls, regardless of whether they are necessary or even helpful in executing the functions assigned to the state by the people.<sup>3</sup>

Thus, partly from mounting frustration with the unresponsiveness of large bureaucracies, and partly from the logic of the “New Public Management” that has emerged in advanced Anglo-Saxon economies in the last decade (see annex V), several developed countries and some developing countries have made increasing use of

“performance” concepts and “results” indicators, both in their managerial practices and in the formulation and execution of public expenditure programs.<sup>4</sup> In some cases, the real difficulties of measuring performance in the public sector have been recognized and the resulting ambiguities tolerated and adjusted to. In other cases, as the man and his wallet, partial or misleading notions of performance have been adopted simply because they are easier to measure.

It is particularly necessary to present the full complexity of the performance issue both because greater performance orientation is very important and because its introduction is sometimes advocated as a very simple and self-evident matter. Earlier chapters have noted the confusion and policy mistakes caused by unclear or conflicting terminology. This is especially true of the terms “performance” and “results”. The formal systems of “performance budgeting” were examined in chapter 3. This chapter begins by examining the meaning of performance, and then reviews in turn the methodological problems of measurement and monitoring; and alternative approaches to improving the performance orientation of the budget process. As elsewhere in this volume, the accent is on benefits as well as costs, risks, and implementation requirements, with reference to both international practice and its applicability in developing countries.

## **2. The semantics of “performance”**

It is essential to start by underlining the difference between “performance orientation”; “performance indicators”; “performance appraisal” (of personnel); and “performance (or program) budgeting”. None of these necessarily implies the others; yet, they are very often confused in practice, with wasteful or counterproductive results.

It is important, too, to underline the difference between “precise” and “quantitative”. Vague indicators of performance are, of course, problematic. But indicators do not have to be quantitative to be precise. First, qualitative measures can be transformed into quantitative ones by surveys, systematic feedback, and other ways of assessing the opinion of the users. The statistical problems are tricky, but in principle the possibilities exist. (For example, the quality of education can be in part quantified by measuring the percentage of parents who are “fully satisfied” with their children’s school.) Second, as lawmaking demonstrates, one can achieve a great degree of

precision by the use of clear language. The objective is not quantification. The objective is accountability—and that can be achieved by indicators that have unambiguous meanings for the assessor and the person or group assessed.

a. *Performance is a relative concept*

Dictionary definitions of “performance” include such alternative terms as “accomplishment”, “achievement”, “realization”, and “fulfillment”. Most of these terms have to do with the *objective* effect of public actions; but some relate to the *subjective* sense of satisfaction experienced as a result of one’s action. Naturally, the economic and public management literature emphasizes the former meaning, not only because of its direct implications for the population, but because subjective satisfaction is extremely difficult to measure and impossible to aggregate.

Accordingly, performance may be defined in terms of *effort* or in terms of *results*. It is a mistake to completely neglect the subjective dimension of “performance”, for it is one important determinant of external effectiveness. Consider what happens if the “effort” dimension is neglected, and incentives are tied *exclusively* to objective results. The more capable underachiever will be rewarded, and the less capable but harder worker will not. The former will therefore receive the message that underachieving carries no negative consequences; the latter that working hard carries no rewards. Both being rational individuals, the level of effort will decline for both and hence for the entire organization.

Recognizing (even if not rewarding) genuine individual effort can do much for morale and serve as a demonstrator for others, thus fostering the effectiveness of the organizational unit. More fundamentally, most individuals consider “a sense of accomplishment” as a strong motivator of their action (independent of salaries, penalties or other material incentives). Thus, if public sector reform programs inadvertently remove that motivation, other things being equal the efficiency of public personnel is likely to decline, and the effectiveness of public action along with it.<sup>5</sup> But this is true only in countries where the public sector and public employees are guided by an ethos of public *service*—a key asset which, no less than physical assets, requires proper “maintenance” on its own terms. Where instead satisfaction is derived from the exercise

of public *control*, emphasis on external results can lessen unwarranted government interference with economic activity, at the same time as it spurs public sector efficiency. It remains true that the normal human drive to do something right<sup>6</sup> should be harnessed, and not disregarded or depreciated. (It is certainly recognized in the more efficient private corporations.)

All of that being said, our recommendation is only to keep these factors in mind. To introduce stronger performance orientation, including in public expenditure management, in most cases *it is advisable to rely on **results**, among many reasons because “effort” is not measurable and is an excellent alibi for lack of results.*

In any event, it is critical to realize that the concept of “performance” is instrumental and not an end in itself, as well as relative: relative to the economic system, to the size of the country, to the role of the state, to the quality of governance, to the prevailing culture, and, of course, to the specific economic sector. What one does with this realization is a different matter; but merely transposing concepts and definition of performance to a different economic and social milieu is most unlikely to produce the desired effects. Indeed, a realistic understanding of local institutions (informal as well as formal) is a prerequisite for the effective introduction of performance considerations into a “nonperforming” public sector.

*b. “Results”: Output, process, outcome, impact*

The measurement of “objective” performance rests on inputs; and/or on one or more of the following results.<sup>7</sup> Using the example of children health services:

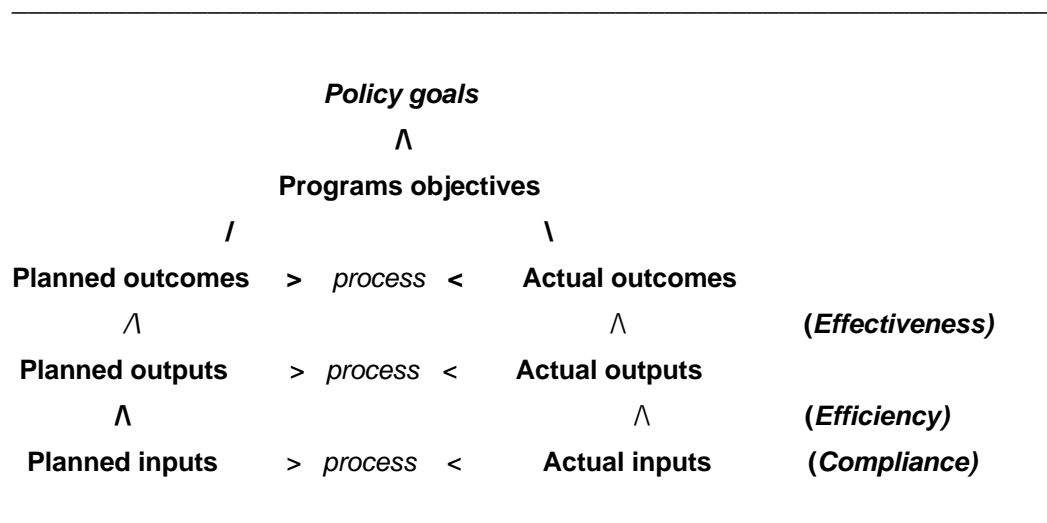
- *inputs* are the resources used to produce the service—e.g., doctors, nurses, hospital equipment, medicines. The social value of inputs is measured by their cost. The budgeting performance criterion corresponding to inputs is *compliance*, i.e., defined as close adherence to budgetary ceilings and ex-ante allocation, as well as a proper but agile procurement process.<sup>8</sup>
- *Output* is the service itself—e.g., number of child vaccinations. The social value of outputs is approximated by the market price for the same or the

closest equivalent service (or, in its absence, by total unit cost). The performance criterion corresponding to outputs is *efficiency*, i.e., minimizing total input cost per unit of output (or maximizing the quantity of output in relation to a given total cost of inputs).

- *Outcome* is the purpose that is achieved by producing the service—e.g., reduction in child mortality and morbidity. The social value of outcomes is subjective and arbitrary, except as revealed by public reaction in the political arena. The performance criterion corresponding to outcomes is *effectiveness*, i.e., maximizing outcomes in relation to the outputs produced;
- *Impact*, often used as a synonym for outcome, is more properly defined as the *value added* from the activity, i.e., the “gross” outcome minus the contribution from other entities or activities. The notion is important in that it takes some account of favorable or unfavorable circumstances beyond the control of those responsible—e.g., a poorer child population. However, impact (in this sense of value added) is nearly impossible to measure, and is not discussed further in this chapter.
- *Process* is the *manner* in which inputs are procured, outputs produced, or outcomes achieved. The value of “good” process is undetermined. For inputs, good process consists of intelligent compliance with input acquisition and utilization rules and, of course, integrity. In some areas of public activity, such as law or politics, “due process” has its own independent validity and is a key element of good governance. (For example, an increase in arrests achieved by violating civil rights would not constitute “good performance”.) In other areas, process indicators are a useful proxy for performance when outputs or (more often) outcomes cannot be defined with clarity. (“Bedside manner” in health services, “rules for free debate” in policy formulation, etc., are examples of process indicators.) Process indicators can be quantitative (e.g., percentage of class time dedicated to student questions) but are usually qualitative. Even then, however, as noted earlier, they can frequently be transformed into quantitative indicators by feedback from users: hospital patient satisfaction can be numerically assessed through a patient survey.<sup>9</sup>

Section B provides examples of input, output, outcome and process indicators in various sectors. Figure 15,<sup>10</sup> is a simple illustration of the relationships among indicators, also useful for their application to the budget process discussed later in this chapter.

**Figure 15**  
**Hierarchy of Performance Criteria and Indicators**



### 3. The link to accountability

The hierarchy of definitions in paragraph 10 suggests a sort of complex production function of public services, whereby the *outcome* of one stage is an *output* of the next stage. Accordingly, in “downstream” activities close to the ultimate user (e.g., urban transport) the output-outcome link is clear and immediate enough to permit using output indicators as a good proxy for outcomes. In “upstream” activities this is not so (e.g., in rulemaking, where “maximizing” public rules is hardly a desirable measure of public performance).

The “accountability tradeoff” noted in chapter 1 states that clearer and more immediate accountability is by definition narrower accountability; and conversely, the link

between action and results becomes more ambiguous the broader and the more meaningful the results. Hence, control through outputs is least workable for complex tasks, (e.g., mental health) and more appropriate for simple processes (e.g., trash collection).<sup>11</sup>

The above implies an “accountability chain”—with accountability clearest and most immediate by the narrowest performance criterion (i.e., compliance with input allocations), and most ambiguous and diffuse by the broadest performance criterion (i.e., net impact).<sup>12</sup> For example, it is fairly easy to hold a village nurse strictly accountable for the output of vaccinations, and to reward or penalize him accordingly; it is difficult to hold him responsible for the outcome of improving the health of village children. Yet, his affirmative involvement in household sanitary conditions, or nutrition, or other health factors, may have more influence on the outcome of improving children’s health than a greater number of vaccinations—*but such involvement will not be motivated by an incentive system that focuses only on the outputs.*

Moreover, in the absence of close supervision, it is difficult to prevent immunizations from being performed with less than the recommended quantity of vaccine (the remaining vaccine “leaking” out of the health delivery system). Therefore, abandoning input and quality controls in favor of output indicators may carry substantial practical risks. (Easy “insurance” could be provided by retaining input and quality controls alongside the output indicators, for as long as may be needed to shake the bugs out of the results-oriented system.)

These considerations are not meant to suggest that outcome indicators are “better” than output indicators, or vice versa. Other things being equal, output indicators are closer to the desired outcomes, and hence more realistic, the closer the activity is to the final user. However, it is certain that accountability can be broad, or strict—but not both. The greater specificity associated with output indicators comes with a loss of relevance; and conversely, it would be difficult to hold public servants strictly accountable for outcomes.

The selection of output or outcome indicators (in cases when the introduction of non-input-based performance indicators is appropriate to begin with) is also heavily

influenced by data availability and information technology. First, good data and good monitoring permit better definition of outputs and thus justify greater reliance on them as a measure of performance. Conversely, when data are lacking or unreliable (or monitoring is weak), measuring performance by outputs generates only game playing and self-delusion. In such cases, the priority must be to place compliance on a firm footing and improve both the relevant data and the monitoring capability—before considering the introduction of results-based performance elements.<sup>13</sup>

Moreover, data collection costs, and more generally the transaction costs of introducing performance indicators in a systematic manner can be enormous. These costs must be assessed realistically and weighed against the benefits expected. It is simply wrong to limit a debate on whether to introduce performance indicators only to the benefits expected from doing so. The introduction of performance indicators is no exception to the basic rule of economics that “there is no free lunch”.

Thus, first, one must never confuse means with ends, and should keep a clear distinction between the objective of introducing greater performance *orientation* in PEM and any particular method for doing so. Greater attention to performance may be stimulated by a variety of means other than the use of actual performance indicators—“moral suasion”, periodic questioning, exposure to the public, peer pressure etc. Second, as noted earlier, the appropriate choice of performance indicators differs for different countries, times, and sectors. Accordingly, the only valid general rule is: *when performance measurement is appropriate and cost-effective, performance should be assessed according to that **mix** of output, outcome and process indicators that is realistic and suitable for the specific activity, sector, and country.*

#### **4. Beware the “law of unintended consequences”**

Introducing new ways of evaluating the results of human action always leads to changes in behavior. Of course, it is precisely the change in public servants behavior—toward ends rather than means—which performance indicators are intended to generate. However, the well-known “law of unintended consequences” states that attempts at modifying behavior may produce unintended behavior, which may be at odds with the objective or even defeat it altogether and make the initial situation worse. The



risk of unforeseen consequences is higher, the greater the ignorance of the informal rules that govern actual behavior in the host society (private and public sectors alike). And, to return to our metaphor, informal rules lie mostly under the surface, like the iceberg which sank the Titanic.<sup>14</sup>

Some examples, all from real life, follow:

- When police performance is measured by the number of police officers “on the beat”, important statistical and analytical functions will be neglected, with adverse consequences on law and order. If the measure is the overall crime rate, the implicit incentive is for policemen to under-report all crimes. If performance is assessed on the basis of a specific crime category, underreporting of that crime and neglect of crime prevention in general are likely;
- If hospital subsidies are based on the length of patients waiting lists, hospital managers and doctors will keep noncritical cases waiting as long as possible and will spend inordinate amounts of time on other cases (higher-quality care for some, none for others); if performance is assessed instead by number of patients treated, the quality of care may suffer (Williams, 1996).
- When an aboriginal tribe in Australia was informed that its sanitation and other subsidies would depend on their performance in keeping sanitary facilities clean, they did so most effectively by thoroughly cleaning the toilets, and then closing them to the public.

The point is to illustrate the care, common sense, and direct sectoral knowledge needed to introduce performance indicators successfully. Indeed, the careless introduction of performance indicators has often generated unintended consequences so serious as to provoke a general backlash against all performance measurement. (This explains the apparent paradox of why those who stand to lose from a new and robust focus on performance rarely object to the introduction of simplistic performance indicators.) The next section discusses in detail problems of definition and measurement for the various types of performance indicators in various sectors.

## **B. FORMULATING PERFORMANCE INDICATORS**

As a memory “fix”, the nature of the problem can be illustrated by reference to the well-known management consulting rule that: “what gets measured, gets done”. There are three conditions for this rule to be valid: (i) the right thing must be measured; (ii) the thing must be measured right; and (iii) there must be consequences if it does not get done. None of these three conditions is easy to meet. Even more of a complication is the obvious corollary of the rule: “what does *not* get measured, does *not* get done”. In the public sector, the least measurable activities may be the most important ones. Finally, as noted, one must keep in mind that rule changes entail behavioral changes: in the long-term, these may be beneficial or dysfunctional depending on the modalities and fairness of the performance assessment system. It is never enough to assess the short-term consequences of changes in organization or in incentives (nor, of course, to limit attention to the benefits expected without consideration of the costs).

### **1. Illustrations of performance indicators<sup>15</sup>**

The performance indicators in table 5 are only examples, but should make clear which particular indicators would make little sense as a measure of “performance” in the specific sector. Yet, the reader probably knows of instances when they are in fact used and may have led to career rewards for the civil servants involved. Fortunately, as noted earlier, whenever data availability and practical considerations permit, a much fuller understanding of performance can be gained by the use of a combination of indicators.

**Table 5. Examples of Performance Indicators**

<u>Sector</u>	<u>Type of indicator</u>			
	<i>Input</i>	<i>Output</i>	<i>Outcome</i>	<i>Process</i>
<i>Administration</i>	No.of staff	No. of policy papers	Better decisions	Openness of debate
<i>Education</i>	Student/teacher ratio	Retention rates	Higher literacy	Encouraging student expression
<i>Judicial system</i>	Budget	Cases heard	Low appeal rate	Assistance for indigent defendants
<i>Police</i>	No. of police cars	No. of arrests	Decline in crime rate	Respect for rights
<i>Corrections</i>	Cost/prisoner	No. of prisoners	Recidivism rate	Preventing abuse
<i>Health</i>	Nurses/population	No. of vaccinations	Lower morbidity	"Bedside manners"
<i>Social welfare</i>	Social workers	Persons assisted	Exits from system	Dignified treatment

## 2. The measurement problem

### a. Backdrop

To some extent, every measure of performance is a proxy measure. For example, the performance of an economic system should be gauged in terms of human well-being.<sup>16</sup> Since that is impossible, it is measured in terms of goods and services produced; and, because these cannot be physically aggregated, their market value is used as a measure of economic performance. "Real GDP" is therefore only a second-order proxy for the true outcome. The measurement problem becomes more complex as one proceeds up the scale from input measures through process indicators. Although the quality issue is ever present, there is no great methodological difficulty in defining and measuring outputs, and even less so, inputs; the issue is their relevance. Similarly, the interpretation of outcomes is rarely in doubt; the issue is their feasibility as a spur to better performance. Outcome indicators are almost always more meaningful, and output

indicators, almost always more feasible. Combining the two factors, performance indicators are most appropriate for sectors where there is a direct and immediate relationship between the government agency's outputs and the desired outcomes.

*b. The CREAM of good performance*

With the above caveat, a performance indicator must be:

- **C**lear—i.e., precise and unambiguous (not necessarily quantitative);
- **R**elevant—i.e., appropriate to the objective at hand (and not used simply because it is readily available);
- **E**conomic—the data required should be available at reasonable cost;
- **A**dequate—by itself or in combination with others, the measure must provide a *sufficient* basis for the assessment of performance;
- **M**onitorable—in addition to clarity and availability of information, the indicator must be amenable to independent scrutiny.<sup>17</sup>

If any one of these five criteria is not met, performance indicators should not be introduced and other ways of assessing and stimulating good performance are needed—including the old-fashioned method of open dialogue with competent and honest managers. At the same time, however, work should be done toward meeting the CREAM rule, to permit the introduction of good performance criteria in the future. In developing countries, circumstances are often inimical to the introduction of result-based performance indicators. However, it is still possible to assess performance in the delivery of basic social services, through opinion surveys and other means of feedback from those who know the situation best: the users of the services.

*c. The measurement of outcomes*

Smith (1996) defines outcome as “a personal valuation of quality-adjusted output”, expressed in the identity: *Outcome = Valuation (Output x Quality)*. The formulation is useful because it calls attention not only to the quality factor (often forgotten in the rush to quantify results), but also to the difficult issue of *whose* valuation should be used. Even when it is feasible to ask the beneficiaries' opinion, the

conceptual question remains of how to aggregate the subjective valuations of the same outcome by different persons, as well as the policy question of how to take into account the different distribution of benefits within the same “average” outcome. Finally, there are public services, such as medical care, for which valuing the outcome only by individuals’ ability to pay is unacceptable in most societies. A fuller discussion would take us too far afield<sup>18</sup>, but it should be clear that the appropriate measurement of outcomes is not a simple matter. Even less simple, of course, is their utilization for performance assessment, because of the variety of influences on outcomes that are outside the control of the civil servant or government organization.

*d. Setting appropriate performance targets*

Once the right indicators have been chosen, the specific levels to be achieved need to be set. The general principle for the setting of any performance target is that it must be challenging but achievable. Both overambitious and too easy targets lead to underachievement. “Benchmarking” and “league tables” are often used to assist in defining appropriate targets.

**C. THE ROLE OF BENCHMARKING IN MEASURING PERFORMANCE<sup>19</sup>**

Benchmarking and performance measurement are closely linked. Performance measurement can be the first step towards improving the performance of a public sector organization and, if backed by an appropriate incentive system, it can help shift organizational focus from inputs to outputs and outcomes and thus improve efficiency and effectiveness. However, the real benefits come from using the performance measures as the basis for internal or external comparisons with the objective of improving the performance of an organization. This is called Benchmarking, which can be defined as the technique of comparing *business practices and performance levels* between organizations to identify opportunities for making improvements in *economy, efficiency or effectiveness* of an organization’s activities.

There are two main approaches to benchmarking, i.e., metrics and process benchmarking. Metrics benchmarking focuses on the calculation of numerical performance indicators such as unit costs, response time and number of customer

complaints, which can then be compared with similar data from other organizations in the same field. Metrics benchmarking is a useful diagnostic tool, as it can help an organization to identify the less efficient areas and provide targets for it to aim at. Generally, most people associate benchmarking with the setting of targets to be achieved, but that is only one part of benchmarking as metrics do not tell you what improvements can be made and how. For that purpose one has to turn to process benchmarking, which focuses on the comparison of the processes and activities underlying the performance of a function. Thus metrics allows you to identify the problem areas, and process benchmarking helps you to find ways to deal with the problem.

The first steps in a process benchmarking exercise involve the preparation of process maps for the activities in the selected area of focus, collection of information on resources consumed by those activities and an analysis of the practices, working methods and policies that determine the performance of those activities. Generally, at this stage many obvious inefficiencies in the existing processes are revealed, the elimination of which can yield significant performance improvements. The next steps are to obtain comparator data, compare the processes, develop recommendations and implement change. After the changes have been introduced, the new values of the performance indicators provide a measure of the improvements achieved and the basis for starting the next round of benchmarking. Therefore, this technique is often referred to in the literature as benchmarking and continuous improvement.

For the purposes of benchmarking, comparators can be either internal or external. The former refers to a situation where comparisons are made between separate divisions of the same organization where similar processes are performed (e.g., multi-site organizations such as the tax, health, or education departments can compare the performance of their offices, hospitals, or schools in different cities). External comparators can be direct competitors, i.e., organizations providing the same product or service, e.g. the public sector could benchmark schools or hospitals run by it against those run by the private sector or NGOs in the same area; or other public sector bodies performing similar processes such as land registration and vehicle registration agencies; or the best organization around, public or private, in the case of similar business processes, such as in the areas of accounting, information systems, procurement, payroll, and customer service. However, It is often helpful to start with

internal benchmarking, i.e., comparing performance measures between different offices or sites, understanding the processes and methods that explain the differences in the measures and what is the best internal practice, before going to outside comparators.

Benchmarking can yield additional benefits in the public sector by introducing a form of competition into the sector. If the results are publicized and general recognition, promotions and career opportunities of public sector managers are linked to the relative performance of their offices, divisions or ministries as demonstrated by benchmarking, it can be a powerful force for improvement in the public sector. However, many people believe that the league table approach can be demotivating for those at the bottom of the league. It is argued that motivation is better fostered by focussing on the gap between the individual unit and the best, the level of improvement, and the moving up the percentiles. Benchmarking also enables meaningful and realistic performance targets to be set for public sector organizations and, if these measures are appropriately designed, it can help to increase the customer orientation of the organization. Finally, process benchmarking promotes team work and cross-functional learning and provides the basis for continuous improvement.

Some of the problems encountered in the application of the benchmarking technique are necessarily the same as those for performance measurement, i.e., capturing the important attributes of the product in question, agreeing on what is to be measured and how to measure it, and the comparability of performance between organizations. In addition, benchmarking is a resource intensive technique and there is the need to restrict the scope of any single benchmarking exercise to the key areas, which can be those that account for the largest component of costs and/or where there are the largest performance gaps. It is also important to avoid excessive detail in the collection of data or mapping of process as it could divert effort from the primary purpose of benchmarking, i.e., identifying better practices and implementing the lessons it teaches. Finally, a critical success factor in benchmarking is the commitment of the senior management to improvement in the performance of the organization.

### Box 41

#### Benchmarking in Hong Kong: Mass Transit Railway Excels in Worldwide Industry Study

Mass Transit Railway Corporation (MTRC) carries 2.4 million customers daily throughout the Hong Kong area. The organization is consistently rated as one of the best in customer service and "best value for the money" among all public transportation in Hong Kong. However, for the past five years, MTRC used *performance and process benchmarking* to ensure that it is the most reliable transportation system in the world.

#### Performance Benchmarking at MTRC

MTRC conducts performance benchmarking annually through its 3-year-old benchmarking project, Community of Metros (CoMET). The benchmarking group spent considerable time defining the 18 Key Performance Indicators to better compare one metro with another. In half of the categories, MTRC was classified as "best in class" but weak in "staff efficiency" and "incident management." To improve these areas, MTRC set up special task forces that met regularly, and site-visited the best performers. However, it was seen that some industry challenges stand in the way of certain improvements, and factors like social system, culture, and purchasing power make it difficult to adapt learnings from the study.

Categories	Key Performance Indicators (KPIs)	Best Practice	MTRC's Score	MTRC's Ranking
Financial Performance (expressed in BCU)	1. Total cost/passenger	0.16	0.42	2
	2. Operations cost/passenger	0.09	0.24	2
	3. Maintenance cost/revenue car operation km	0.59	1.30	5
	4. Fare revenue/passenger	1.15	0.61	4
	5. Total commercial revenue/operations cost (including maintenance)	6.19	6.19	1
	6. Operations cost/revenue car operating km	0.20	1.05	3
	7. Total cost/revenue car operating km	0.77	4.12	2
Efficiency	8. Passenger journey/total staff + contractor hours	64	62	2
	9. Revenue capacity km/total staff + contractor hours	2,253	1,960	2
	10. Revenue car km/total staff hours	14	6	7
Asset Utilization	11. Passenger km/capacity km	34.07%	23.64%	3
	12. Capacity km/track km	596,583,750	596,583,750	1
Reliability	13. Revenue car operating hours between incidents	12,074	12,074	1
	14. Car operating hours/total hours delay	50,978	50,978	1
	15. Trains on time/total trains	99.79%	99.79%	1
	16. Revenue operating car km/total incidents	361,718	361,718	1
Service Quality	17. Total passenger hours delay/1000 passenger journeys	2.38 min	2.38 min	1
	18. Passenger journeys on time/total passenger journeys	99.80%	99.80%	1

#### Process Benchmarking in Action

In 1995, MTRC and nine founding organizations came together to discuss several essential, but generic, processes that would benefit most members and mutually agreed on the supplier/vendor process. Based on the benchmarking findings from the supplier study, MTRC redeveloped its suppliers' selection criteria and created a purchasing system by fully computerizing its purchasing orders. These changes reduced the material supplier base by 40 percent (from 10,000 to 6,000) since 1996 and achieved 30 percent cost savings in rail supply and 20 percent cost savings in uniform supply. MTRC also has reduced its damage/shortage/rejection rate by 49 percent in the past two years and received better pricing due to quantity discounts and better shipping arrangements.

Source: *Benchmarking in Practice, Issue 11, American Productivity and Quality Center, Internet Edition, 1998, by Vicki J. Powers*



**D. CONTRACTING-OUT: A LOGICAL EXTENSION OF PERFORMANCE ORIENTATION?**

The prospect of losing customers is a well-known and powerful stimulus for performance in a private enterprise, but—despite the absence of the profit motive—can also prod a public sector organization to perform better. In addition, contracting the delivery of social services to the private sector can, if done right and under certain circumstances, lead to efficiency savings in and of itself. Therefore, the possibility of contracting out certain public services or functions should rank near the top of the list of questions to be asked periodically in government organizations. However, contracting-out is only one market-related mechanism to improve efficiency and effectiveness. It is dealt here at length because of the need for a full understanding of the uses and limits of this mechanism in view of the increasing frequency of its introduction in developing countries.

**1. What is “contracting out”?**

Contracting-out is the transfer to the private sector of the implementation of activities financed and previously delivered by the government. The practice has experienced a recent resurgence (as part of the New Public Management; see annex V) but is common in history. For example, “tax farming” was prevalent in ancient China, Greece, Rome,<sup>20</sup> and, more recently, Thailand, which until 1875 did not have a governmental organization for tax collection.

Generally, under contracting-out arrangements, the activities transferred to the private sector remain financed by the government. Separating the financing from the delivery allows the governmental purchaser to choose from among different suppliers and to control costs and quality standards, without having to take into account particular interests of its staff. Contracting out aims at improving efficiency and curbing costs by promoting competition and/or clearer identification of costs. For example, in New Zealand the audit office contracts out a number of its activities,<sup>21</sup> and in the U.K. “partnering” is used where the tendering process is not competitive owing to an undeveloped market for the services and special qualifications of the contractor.<sup>22</sup> Integral to a possible decision to contract out is the “market-testing” approach, by which

government assesses whether the public service in question can be better delivered by the private sector.<sup>23</sup>

Build-operate-transfer (BOT) or build-lease-transfer (BLT) schemes concern private financing of public investment. In BOT schemes the private sector finances the initial investment; recoups it through the profits from a concession to operate the project over a determined period; and, at the end of the concession, transfers the assets to the government. BOTs are seen as a means of attracting private and foreign capital.<sup>24</sup> BOT schemes have been adopted for years in some developed countries (the most publicized one being the Anglo-French Channel Tunnel).<sup>25</sup> Recently, these schemes have been introduced in developing countries. Asia has a variety of BOT projects, including bridges and the airport in Hong Kong, power and railways in China, highways and airports in Malaysia, telecommunications in Thailand, mass transit and power in the Philippines. The US\$1.8-billion Hub River thermal energy project in Pakistan involves BOT arrangements second in size and complexity only to the Channel Tunnel Project.<sup>26</sup>

Some BOT contracts guarantee the contractor against losses in operating the project (in the example of a tollroad, if traffic is less than projected the government could ensure the servicing of debt contracted for the project). In other BOT contracts the contractor is formally responsible for the success or failure of the project. However, if the contractor goes bankrupt, in a majority of cases the government will have to continue operating the project and to subsidize it. (See the discussion on implicit contingent liabilities in chapter 2.)

## **2. Managing the contracting-out process**

Government activities cannot be contracted out simply on the basis of standard contract management, but needs a special assessment.<sup>27</sup> To begin with, it is necessary to define clearly the business need and to identify specifically the activities to be contracted out. It is also important to evaluate likely changes in conditions (e.g., service increases and investment requirements); review issues of coordination between the activities to be contracted out and the other relevant governmental activities; and assess whether governmental activities in other agencies could be incorporated into the project to increase its efficiency. The contracting out needs to be organized on the basis of a

purchaser-provider relationship between the government agency and the contractor. Therefore, the quality of the contractor's management and the nature of the relationship are important. A variety of options should be considered regarding the type of agreement (lump-sum contracts, price-per-unit contracts, shared profits, etc.); the objective (e.g., cost saving only or service improvement); etc. Project costs should be assessed (when possible) based on the experience on similar projects or specific studies; performance standards should be clearly stipulated in the contract; and the contract should incorporate provisions regarding contractor nonperformance and dispute resolution mechanisms.

**Box 42**  
**Risks and Opportunities in Contracting Out**

In *Malaysia*, the government signed a novel and ambitious 28-year concession with a private consortium to upgrade, rehabilitate, and extend the entire country's sewerage system. Although the estimated US\$2.8 billion contract was awarded in 1993, progress has been slow, primarily because of significant public and commercial backlash from tariff collection and tariff increases. Malaysia's experience points to the unique risk allocation issues raised by private provision of retail sanitation services in instances where these services have never been centrally provided before, the legal right to cut off service for nonpayment is absent, and sewerage and water services are billed separately.

In *Argentina*, the city of Buenos Aires delegated the management and investment responsibility for its water and sanitation systems to a private consortium. Under the terms of the 30-year concession, the consortium will invest US\$4 billion in upgrading, rehabilitating, and extending the systems. In three years, the consortium has brought dramatic operational and financial improvements through reduced UFW and higher bill collection rates. The success can be traced to the significant steps the Argentine government took to ensure the financial viability of the concession: raising tariffs prior to privatization, assuming the state water companies' liabilities, financing a voluntary retirement program, providing a guarantee that the concession company would cut off service to consumers for nonpayment, and creating an independent regulatory authority to prevent politicization of the concession. Soon after the award of the concession, however, tariffs had to be raised ahead of schedule because the government agreed with the operator's view that the physical state of the systems was worse than anticipated.

Source: *Finance and Development*, March 1997.

*Contracting out an activity does not discharge the government agency from its responsibility for that service.* The agency has the obligation to monitor the performance of the contractor to ensure that standards are met and the contract is fulfilled. Assessment and management of risks are important aspects of contract management. The agency needs to keep up its technical knowledge of the service, to be able to monitor the performance of the contractor and to audit performance information from the contractor.

**Box 43**  
**Why did the lights go out in New Zealand?**

Following the deregulation of the New Zealand energy industry under the 1992 Energy Companies Act, Mercury Energy Limited was incorporated on October 1993 as the successor to the Auckland Electric Power Board (AEPB). The 1992 Energy Companies Act set the deregulation process in motion by requiring all power boards to come up with a plan to turn themselves into successful businesses. Mercury Energy's plan, which was accepted by the government, included creating shares and placing them in the hands of newly formed Auckland Energy Consumer Trust (AECT). That made the AECT principal shareholder of Mercury Energy. Each year, Mercury Energy pays the AECT a dividend of at least 50 percent of its after-tax profit. The AECT, after meeting its operating costs, distributes the surplus to customers of Mercury Energy.

Mercury Energy covers both electricity distribution and power distribution activities. The distribution or lines business involves the operation and maintenance of a regional network covering the city of Auckland. Currently, around 68 percent of Mercury Energy's distribution system uses underground cables. The company has about 250,000 customers, including 50 of the country's top 200 electricity consumers, and 217,000 residential customers.

On February 20, 1998, a power crisis hit Auckland when four major cables feeding the central business district crashed. International experts engaged by Mercury Energy have found possible causes for the cable failures: the exceptionally hot and dry weather, problems in the backfill and ground in which the cables were installed, steep slopes down which some sections of the cables were laid, vibrations from road and rail traffic, and the cutting of control cables by contractors.

Whether the causes of the power failure are under the control of Mercury Energy or not, the company's competence, standards and practices as Auckland's major provider of power, have been put into question. The ministerial inquiry into this incident distributed blame between Mercury Energy and its predecessor, the AEPB because both neglected the evidence of increasing unreliability of the cables supplying the Auckland CBD. Mercury Energy, however, gets a bigger part of the blame as it seems likely from the inquiry's conclusions that it did not properly evaluate the risk of supply interruptions which have been increasingly growing with the rising load on unreliable high-voltage cables.

Moreover, the inquiry report concluded that the indirect nature of the trust ownership of Mercury Energy may have had an effect through "absence of clear Board accountability through effective shareholder and/or market disciplines", a vital objective in a network industry with monopoly characteristics. Likewise, Mercury's contracts with its customers do not clearly define what supply risks are involved and unless exclusions and limitations were freely and equitably negotiated between supplier and customer, the supplier should bear the residual liability.

Sources: *The Age*, Melbourne Online, various issues, 1998; and Rob Laking, Director of Master of Public Management, Victoria University of Wellington, 1998.

### **3. The need for caution**

As noted, contracting out can be an effective tool for promoting efficiency and improving the delivery of certain public services. Possibilities for contracting out must be taken into account when preparing the budget. When preparing and reviewing ministries' budget requests, it is always advisable to ask whether a more cost-effective private solution could exist, and move to contract out the service if the answer is yes. However, contracting-out cannot be a substitute for a sound restructuring of the public sector, or for privatization if the service in question does not properly belong in the public sector. Nor is contracting out a panacea; indeed, it carries fiscal, efficiency, and governance risk if it is not well designed and monitored. It is always necessary, therefore, to determine accurately the contractual and market conditions in which the possible private solution can be implemented.

**Box 44**  
**Why Sydney Siders Had to Boil Their Water**

Until 1995, Sydney Water, a state-owned corporation, was responsible for Sydney's water. As water quality guidelines became stringent, Sydney's raw water came under increasing stress and the Sydney Water Board decided to contract for a privately built-owned-and operated (BOO) system for water treatment. Several factors persuaded the Board to adopt the BOO system for water treatment. It was facing major capital outlays to upgrade and expand wastewater treatment capacity, and was about to be corporatized, thereby involving the private sector and providing access to a full range of international technology. Moreover, the growing competition made the Board realize its relative inexperience in filtration systems. In 1993, two consortia were contracted for water treatment plants: the Australian Water Services and North-West Transfield. A year later, a third contract was awarded to another consortium, Wyuna Water. By the end of the century, the drinking water consumed in Sydney will be treated by the three plants.

On July 31, 1998, Sydney residents were warned to boil tap water following the discovery of a parasitic contamination affecting the entire metropolitan area. Sydney Water confirmed that the source of contamination was the Prospect water filtration plant, a plant operated by Australian Water Services. Sydney Water's contract with private treatment plants costing taxpayers US\$3 billion does not require the target of giardia cysts and cryptosporidium, the organisms that invaded the drinking water supply.

Several years ago, Sydney Water abandoned plans to clean its reticulation network, a move that could render the four contracted treatment plants ineffective. Moreover, Sydney Water took more than two years to finalize a memorandum of understanding (MoU) for the Department of Health to take over regulation of water health matters, despite having been directed to do so two years ago by the Ministry for Urban Affairs and Planning. Responsibility for the problem thus appears to be shared. The event demonstrates anew the need for thoroughness and attention to quality control when contracting out basic social services.

Source: *The Sydney Morning Herald*, *The Herald Sun*, and *The Courier*, various issues.

In any case, caution is needed. The experience in practice with lump-sum contracts and “partnering” is similar to that with management contracts for public enterprises adopted by many developing countries in the 1980s.<sup>28</sup> Generally, these contracts have not helped in rehabilitating ailing enterprises or improving their efficiency, and in many cases have led to asset stripping and “profit milking” by the management. (When managerial contracts were associated with substantial equity investment by the new management, these problems were significantly alleviated.)

A competitive environment is generally necessary to benefit from contracting out. After reviewing several surveys of contracting experiences in the U.S. that show uneven results, Donahue concludes:

*First, the profit-seeking private firm is potentially a far superior institution for efficient production. Second, that productive potential can be tapped only under certain circumstances. Public versus private matters, but competitive versus noncompetitive usually matters more... Half of a market system—profit drive without meaningful specifications or competitive discipline—can be worse than none.*<sup>29</sup>

Particularly in developing and transition economies, benefits from contracting out depend from progress with reforms to build a competitive environment. Public enterprises to which contracts are granted should be corporatized, and the role of the state as “principal” separated from the functions of management as “agent”.<sup>30</sup> There should be an arm’s length relationship between the private or public contractors and the government. And an adequate market-oriented legal framework must be in place.

Contracting out is sometimes a way of slipping budgetary constraints rather than a deliberate choice on efficiency grounds. In theory, the financial risk should be transferred to the contractor, but contracts often include explicit or implicit government guarantees. Because of the importance of the service to the public, when the contractor fails to provide the service correctly or goes bankrupt, the government has no practical alternative but to intervene and give financial support to the activity previously contracted out. Some contractors therefore use contracting-out agreements to get the contract,



without intending to submit themselves to real market discipline afterwards. Contracting out may also diminish transparency, since it substitutes "commercial confidentiality" for accountability and thus escapes legislative controls.

When the government is obliged to support an ailing project implemented under a BOT contract, the fiscal cost may be particularly high, as shown by the Mexican experience described in box 46. This calls for a careful analysis of the legal and economic aspects of BOT arrangements. The usual cost-benefit analysis of projects undertaken under BOT schemes must be undertaken, but further assessments of risks, variants, etc., are required. The legal negotiations may need years. A BOT arrangement should never be an excuse to launch an unprofitable project. A genuine private solution must be considered. When the government cannot find a genuine private solution, the reason is often that the project is not viable in the first place. The corruption risk of BOT arrangements is of special concern. Compared with normal procurement, the complexity of BOT arrangements provides greater opportunities for corruption. For example, in a country such as France, where corruption within the civil service is nearly nonexistent, several recent judicial proceedings revealed corruption of local authorities through BOT contracts.

**Box 45**  
**Contracting Out Gone Wrong: Two Examples**

In the 1980s, local authorities in the United Kingdom, faced with financial stringency, resorted to a range of private funding vehicles to evade public expenditure control. These unconventional means of finance involving private parties become known as "avoidance instruments". For example, many local authorities resorted to sale-and-leaseback arrangements with existing assets, in some cases reaching the extremes of realizing cash through sale and leaseback of street furniture such as lampposts or parking meters.

Mexico launched in 1987 an ambitious program for contracting out the construction and operation of roads under BOT arrangements. Initially, the arrangements appeared to be successful, and more than 5,100 km of new toll roads were built. However, resources were allocated poorly and were used before they were needed; construction periods turned out to be 55 percent longer than had been agreed with the contractors; vehicle traffic 37 percent lower than projected; and investment 29 percent higher than agreed. The profitability of the roads was naturally far lower than had been anticipated. The Mexico economic crisis of 1995 aggravated the financial situation of the toll roads under concession to private companies, forcing the government to implement a plan of emergency support of US\$2.2 billion. As a consequence, the participation of the public sector rose to 40 percent of the capital stock of companies holding the concessions, and the concession terms were extended to allow private investors a greater opportunity to recover their investment.

Sources: David Heald "Privately financed capital in public services", The Manchester School, 1997; and Robert Barrera, "Contracting-Out Highway Development and Operations in Mexico", in *Contracting out government services*, OECD, 1997.

## **E. KEY POINTS AND DIRECTIONS OF REFORM**

### **1. Key Points**

Greater performance orientation in public expenditure management is a goal, and must not be confused with any specific means of encouraging it. In particular, better performance in budgeting should never be confused with “performance budgeting”, which may lead to better or (more often) worse performance depending on circumstances. Performance is a relative concept, which can be defined in terms of effort or in terms of results. The subjective dimension of performance should never be neglected, and genuine effort should be recognized, or it will no longer be exerted. However, it is advisable in most cases to define performance in terms of objective measures.

Objective indicators of performance can relate to:

- input—the resources used to produce a service (e.g., doctors)
- output—the service itself (e.g., number of vaccinations)
- outcome—the purpose achieved by producing the service (e.g., lower morbidity)
- process—the manner in which inputs are procured, outputs produced, or outcomes achieved (e.g., good “bedside manners”).

The output of one stage is an outcome of the previous stage and input into the next. Thus, in activities close to the ultimate user, outputs are a good way of contracting with service providers. In upstream activities instead (e.g., medical research) the measurement of performance is much more ambiguous. There is an “accountability tradeoff”, by which accountability can be strong or broad but not both. In any case, the *quality* of the service requires explicit monitoring, or performance indicators may inadvertently lead to lower quality. The selection of appropriate performance indicators, therefore, depends on the nature of the service as well as the circumstances of the country in question. The only general rule is that—in those cases when performance measurement is demonstrated to be appropriate and cost-effective—performance

should be assessed according to that *mix* of input, output, outcome and process indicators which is realistic, cost-effective, and suitable for the specific activity, sector, and country.

Among the several cautions the risk of counterproductive behavior ranks high. It is essential to think carefully about the impact on actual behavior of using any specific indicator of “performance”. For example, when an aboriginal tribe in Australia was told that its subsidies would depend on keeping sanitary facilities clean, they did so most effectively by cleaning the toilets thoroughly and then closing them to the public. With these caveats, good performance indicators should meet the “CREAM” criterion: they should be Clear, Relevant, Economic, Adequate, and Monitorable. If any one of these requirements is not met, the indicator should not be used. When indicators are used, the next question is setting the appropriate target: the general rule is that a target should be challenging but achievable.

*Contracting out*—the transfer to the private sector of the implementation of activities previously performed by government is in a sense a logical extension of performance orientation (and belongs, as well, in the realm of the third PEM objective of good operational management). Contracting out is the transfer to the private sector of the delivery (not the financing) of government services. It offers the potential for efficiency increases both in the delivery of the service contracted out and, through the “market-testing” effect, in the government delivery of other services. However, contracting out calls for great caution, and requires, among other things:

- a competitive environment;
- definition of the business need and of the activity to be contracted out;
- coordination with other related governmental activities;
- careful consideration of the quality of private management;
- protection of transparency and of service quality;
- specification of performance standards (which meet the CREAM criterion) and of consequences for non-performance; and
- very close monitoring of contractor’s performance.

The risks associated with contracting out are particularly great in the case of Build-Operate-Transfer (BOT) arrangements, whereby a private entity finances and builds the facilities, then recoups its investment through an exclusive concession to operate them, and finally transfers them back to the government. First, the complexity of such arrangements provides greater opportunities for corruption; second, risk assessment is essential, for the government may well be obliged to foot the bill if the private contractor bankrupts or defaults.

It would be a gross oversimplification to attempt to summarize further the summaries of general reform recommendations shown in Chapter 17 to which the reader is referred. The general prescription for successful reform are, in fact, the same as the broad themes of this book": (i) never transpose into a different social and economic context reforms introduced elsewhere, without a realistic assessment of their impact and requirements and appropriate adaptation if necessary; (ii) never move beyond the basics until certain that the basics have been set right; (iii) never hope for a quick-and-easy technical solution to complex and long-standing budget process problems; and above all (iv) never assume that the "experts" are invariably right. Competition and contestability can be as effective in screening out bad ideas as they are in screening out bad products. Therefore: question, question, and question some more. If the advice is good and the experts are right, they will be able to answer to everyone's satisfaction. More importantly, local officials can then implement the reforms themselves, with external advice, certainly, but only in a supporting rather than a controlling role.

## **2. Directions of reform**

Injecting new formal performance-related elements into the budget process requires extreme care, both because better performance orientation is critical for improving public expenditure management and because there are many wrong ways of pushing it and only a few ways of doing it right. The lessons of international experience for the reform process in this area are thus essentially the following:

- Never confuse the objective of better performance orientation with any one of the specific instruments for achieving it. There are many ways to foster performance, short of making formal changes in the budgeting system;

- If the public expenditure management system is performing reasonably well, be particularly mindful of the risk that changes may actually make the situation worse. (Symmetrically, if the budget process is extremely weak and corrupt, radical changes may be the only way to improve it.)
- Consider carefully the probable impact on individuals' behavior, especially in multi-ethnic societies or very small economies.
- Understand clearly the different uses and limitations of input, output, outcome and process indicators, and tailor the use of each to the specific sector and issue in question. Whenever possible, avoid using any single indicator to assess performance.
- Assure robust monitoring of performance, with swift and predictable consequences.
- Build-in provisions for the systematic assessment of *performance of the performance system itself*. It is inherent in the logic of the system that it, too, must be subject to a reality test, and to periodic proof that its concrete benefits have outweighed the cost.
- Beyond these caveats, it is important to continuously look for any possibility to expand the "service awareness" of government administration; raise the rewards for good performance (not necessarily monetary) and the sanctions for unsatisfactory performance; and keep under constant review the possibility of introducing the various tools for measuring and monitoring performance. In all these tasks, systematic feedback from the service users and the public at large is invaluable, and so is an informed and aggressive free media.
- The process can consist of first picking one or two government departments that provide services directly to the public; introduce simple performance measures at an acceptable cost (including transactions cost); monitor closely

the functioning an impact of the measures; debug the measures and adjust as needed; gradually expand the application of performance measures to other governmental areas as and when appropriate; and stop when reaching the point of diminishing returns. The performance indicators can be used right away in the dialogue during the budget preparation, but direct and mechanical links to budgetary appropriations should be avoided.

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<sup>1</sup> However, for units within a private enterprise the problem of measuring performance may not be any easier than in the public sector. This is especially true in a large enterprise, suggesting that “size” may be as important a variable as the public or private nature of the activity.

<sup>2</sup> For a private corporation, success can be assessed by a variety of related quantitative measures: share price, profit, dividend distribution, turnover, market share, etc. None of these indicators are applicable to government activity. Hence, among other implications, private management techniques (“management by objectives”, etc.) might provide useful pointers, but cannot be transposed to the public sector.

<sup>3</sup> As in Heller’s work of fiction, *Catch-22*, in which the commanding general insists on a “tight bombing pattern” whether or not the target is hit, and reprimands a pilot who destroyed the assigned target but whose bombs did not hit in the prescribed close pattern.

<sup>4</sup> Primarily the U.S., the U.K., Australia, and New Zealand. New Zealand has gone farther in this direction than any other country (see OECD, 1997). In the U.S., which has the longest experience of disappointments with “performance” or “program” budgeting, performance orientation in the budget process is now being pursued less mechanically, through the 1996 Government Performance and Results Act (GPRA; see U.S. GAO 1996a and 1996b, and U.S. GAO 1997a and 1997b; on the general question of using performance measures in the U.S. budget, see U.S. CBO 1993).

<sup>5</sup> In the ancient adage: “Man does not live by bread alone”. A reductionist view of human nature risks, in time, reducing sharply public sector effectiveness, and possibly increasing the risk of corruption.

<sup>6</sup> What Thorstein Veblen called “the instinct of workmanship”.

<sup>7</sup> These measures are discussed in a variety of sources, e.g., UK Audit Commission, 1986; Beeton, 1988; and Federation des Experts Comptables Europeens, 1991.

<sup>8</sup> As noted in Chapter 1, “economy”, i.e., least-cost provision of inputs is frequently used as a performance indicator. Although it is an administratively convenient concept, as it linked to the procurement function, it is subsumed in efficiency and thus not independently useful for analysis or policy.

<sup>9</sup> Note that not all useful data concerning a public service are necessarily performance indicators. For example, the percentage of arrests from citizens’ direct complaints is a useful statistic for law enforcement, but says little if anything about the performance of the law enforcement apparatus.

<sup>10</sup> The illustration is our adaptation from David Shand (1998), who in turn derived it from Boyle (1989), Jackson (1991), and OECD (1994).

<sup>11</sup> Perrow, 1986 (quoted in Robert Laking’s “Don’t try this at home: A New Zealand approach to public management reform in Mongolia”, paper presented at an ADB training event, Nov. 1998).

<sup>12</sup> For process indicators, accountability can be stronger or weaker depending on the nature of the public activity.

<sup>13</sup> Consistent with the need to “get the basics right”, this principle is analogous to the conclusions of the chapters on budgeting and on accounting: cash-based systems must be strong and well-rooted before considering a move toward program budgeting or accrual accounting.

<sup>14</sup> For an elaboration of the distinction between formal and informal institutions, and the concept of “path dependence”, see North, 1991.

<sup>15</sup> A large number of indicators for most sectors can be found in UK Audit Commission, 1986b, and 1993; Carter et al, 1992; and OECD, 1997. For education, see Johnes, 1992, and Reynolds, 1992; for health, Wilkin et al, 1992, and Williams, 1995; for law enforcement, Fowles, 1996 (in Smith, 1996); for public housing, Bines et al, 1993; for social security, Deleeck et al, 1991.

<sup>16</sup> “Real income”, in Irving Fisher’s sense.

<sup>17</sup> Shand, 1997, lists many more requirements for performance indicators. However, several are desirable but not mandatory, and others are in fact different dimensions of the five requirements listed above.

<sup>18</sup> The reader is referred to Smith (1996) and, for the health sector, to the outstanding analysis in Williams (1996).

<sup>19</sup> We are indebted to Naved Hamid and Gie Villareal for this section.

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<sup>20</sup> See John Brewer, *The sinews of power: war, money and the English state*. Knopf, 1989 quoted in Premchand (1993).

<sup>21</sup> *Contracting out government Services*. OECD, 1997.

<sup>22</sup> "Strategic partnering in government". CPU guideline no 57. U.K. Treasury.

<sup>23</sup> The British Council, *Governance: Public sector reform*, Glossary of terms

<sup>24</sup> At least in developing countries. In developed countries with open financial markets, this advantage of BOT schemes is questionable. See Heald, 1997.

<sup>25</sup> For about 40 years in France for toll-roads and water supply under the name of "Public service concessions." See D. Heald. "An evaluation of French concession accounting" .*The European Accounting Review*. 1995.

<sup>26</sup> James Leigland "Privatization of Public Enterprise in Asia: Current patterns and emerging issues" in Naomi Caiden "Public Budgeting and Financial Administration in Developing countries". Jai Press. 1996.

<sup>27</sup> See U.K. Treasury, "Contract management"; Central Unit for Procurement. Guidelines no 61. 1998.

<sup>28</sup> A management contract is with a private contractor; a performance contract (pioneered by the French *contrat-plan*) is between the government and the public managers of the state enterprise.

<sup>29</sup> John D. Donahue. *The privatization decision*. Basic Books, 1989

<sup>30</sup> For a discussion of corporate governance in transition economies, see Dominique Pannier and Salvatore Schiavo-Campo, "Corporate governance of public enterprises", World Bank, 1995.